

THE ECONOMY OF BULGARIA – July 2012

Summary Report

Of the Center for Economic Development

Complete text of the Report in Bulgarian can be found at www.ced.bg

MACROECONOMIC DYNAMICS. Economic growth. The Bulgarian economy is still stagnant. Although it registers a weak growth in GDP in the first quarter of 2012, NSI data show (by seasonally adjusted series) a continuing delay in growth. On an annual basis, GDP growth drops to 0.5% (from 0.9% in the last quarter of 2011) and over the previous quarter, growth is zero (compared to 0.1% for the fourth quarter of 2011). On the other hand - by unadjusted series - growth is present and demonstrates acceleration (from 0.3% to 0.9% yoy). However, while GDP grows in the first quarter of 2012, GVA produced in the economy is shrinking - it decreases on an annual basis (by 0.2% according to adjusted, and by 0.9% according to unadjusted data), and on a quarterly basis a decline is observed for a third consecutive quarter. The reported in the first quarter of 2012 weak GDP growth is completely due (by the production side) to growth in adjustments.

Quarterly data on GDP and its components in the first quarter, complemented with the picture of monthly data for the first 5-6 months of 2012, i.e. NSI data available as of the July 2012 (quarterly national accounts and monthly data of short term business statistics and business surveys) do not point to a convincing positive overall economic **growth for the second quarter. It is more likely to expect dynamics around zero.**

It must be stressed that the mixed dynamics of gross domestic product and gross value added in the economy for the first quarter of 2012 is too disturbing. Alarming is the fact that in the last two consecutive quarters - with reported growth in comparable prices - the volume of GDP at current prices is lower than a year ago. The current volume of GVA in the economy also reports a lower annual value. It is particularly worrying that for a third consecutive quarter total GVA for the economy is continuously shrinking on a chain basis, i.e. over the previous quarter.

Bulgaria, and everyone in the country, needs a balanced growth, with main driver of growth production and not consumption, since only production creates income, which can be consumed. Financing consumption through crediting is very dangerous, if production is unable to pay for it – there are enough such examples in the southern part of Europe. GDP data for the first quarter (yoy) are disturbing because they signal a problem with growth - gross value added is shrinking, and final consumption is growing. On a quarterly basis, however, the contraction in final consumption means that it is still trying not to oversize its shadow.

Expectations for growth of the economy throughout 2012 are weak and our forecasts are for a growth of around 1% which we expect to be shaped by better economic performance in the second half.

The rationale behind our expectations about the dynamics of GDP components for the second quarter, and for the year will be clarified by starting with the production side of GDP in the three sectors which, according to annual data performed best in 2011. The sectors "... industry ...," "professional activities ...," and "... information ..." demonstrated annual growth rate for 2011 and all three together created nearly 31% of GDP for the last year. In the first quarter of 2012 unfavorable dynamics is observed in all three sectors. Potential improvement is possible in all three sectors in the second quarter.

In the first quarter of this year growth of value added in industry continues to slow down (sector "*Mining and quarrying; manufacturing; production and distribution of electricity, heat and gas fuels; water supply; sewerage, waste management and recovery*"). This sector was the fastest growing in 2011 (with growth of 9.1%) and has the largest share in GDP (21.2%). For the first quarter of 2012, however, it records a zero growth in value added by seasonally unadjusted data and only 1.8% by adjusted (correspondingly 1.8% and 5.1% for the last quarter of 2011) and insignificant increase over the previous quarter (0.1% to 1.3% in the fourth). However, although weakening in growth of comparable prices, the volume of value added by current prices of the sector is already for a second consecutive quarter below the corresponding period of previous year and this is disturbing.

There is weak, but still positive dynamics of value added in industry for the second quarter of 2012. Since NSI **monthly data** of industrial production dynamics on an annual basis in April and May are positive, unlike those from the first three months of the year when they were negative, there is reason to expect that the second quarter will be better regarding the dynamics of value added in the sector, compared to the first quarter of 2012. The fact that business climate rates in industry for the second quarter look better supports our expectations for a better second quarter. For the whole 2012 expectations are that industry will grow, but probably much weaker compared to last year.

At the beginning of 2012 it is decline, not growth recorded in the other two sectors, which demonstrated growth in 2011. Although the significance of sector "*Professional research and technical activities; administrative and support activities*" for the economy is relatively low (4.7% share of GDP in 2011), it was second in size of reported growth after industry (8.1%) of value added for 2011. After this impressive growth in 2011 the declines in the first quarter of 2012 are somewhat surprising (by 0.5% in unadjusted and 2.4% in adjusted data yoy, and by 3.2% on a quarterly basis), especially compared to the double-digit growth in value added yoy for the last quarter of 2011. Similar decline in the dynamics of the sector was seen in the second quarter of 2011. Expectations are that it will recover and relatively quickly will turn to growth.

The third and last sector that registered growth in 2011, although quite lower (1.9%) is "*Creating and distributing information and creative communication*" (4.8% share in GDP for 2011). Unfortunately this sector also registers a decline in the first quarter of 2012 - both on annual and quarterly bases. Its contraction in value added on an annual basis is by 7.2% in unadjusted and by 2.3% in adjusted data, and on a quarterly basis - by 1.9%. Similar deterioration in the sector was seen in the second quarter of last year, and then it still recovered to growth for the year as a whole. Expectations are for a similar development in 2012 as well.

Let us now look at the quarterly dynamics of the remaining 7 sectors, presented in order of increasing rate of decline for 2011 as a whole.

The dynamics of sector "*Financial and insurance activities*" is declining. In retrospect this sector slowed its growth only in 2010, and in 2011 registered a very slight decrease (0.1%). The sector

share in GDP is 7% for 2011 (highest since 2006). After low growths in the fourth quarter on an annual basis, and a quarterly decline, for the first quarter there is a decrease on an annual basis in unadjusted data and a weak growth in adjusted data, but the decline on a quarterly basis increases. It is possible all three indices to register a decline or a weak growth for the second quarter of 2012. More active growth may be expected in the second half of 2012.

Sector *"Real Estate"* (with a slight decline of 0.6% and with 8.1% share in GDP for 2011) grew in the last two quarters of 2011 with increasing pace (both on annual and quarterly bases). For the first quarter of 2012, however, it demonstrates much lower annual growth and a quarterly decline. Improvement is hardly to be expected before the third quarter of 2012.

Sector *"Government, Education, Human Health and Social Work"* was next in size of decline in 2011 (down by 1%, with a 10.8% share in GDP for 2011). For the first quarter the sector declines yoy, but remains at zero on a quarterly basis. It may register slight growth in the second quarter of 2012.

The next three sections ("Trade ..." "Construction," "Agriculture ...") register equal decline for 2011 (1.1%). Let us look at them by quarters in a descending order according to their share in the economy for 2011.

Second in importance after the industry for the economy with a 17% share of value added in GDP for 2011 is sector "Trade, repair of motor vehicles and motorcycles; transportation; storage; hotels and restaurants." For the last two quarters of 2011 the sector is shrinking on an annual basis and on a quarterly - in the fourth quarter. Results for the first quarter are not mixed – seasonally adjusted data show growth both yoy and quarterly, unadjusted, however, again record a decline. **Monthly data** on turnover for April and May are slightly better than in the first three months. In April and May rapid improvement of the business climate (in retail) is registered, which, however, deteriorates sharply in June. Growth of value added in the sector may be registered for the second quarter, but it will be relatively weak.

Sector *"Construction"* (with a 5.6% share in GDP for 2011) recorded high growths on an annual and quarterly basis for the third quarter of 2011, followed by deep drops in the fourth quarter. For the first quarter of 2012 the annual dynamics is weak and contradictory, and yet – on a quarterly basis construction records a weak growth. The business climate in the sector improves considerably in April and remains around this level in May and June. **Monthly data** for the annual change in construction output in April and May look better than for the first three months of the year. More considerable growth of value added in construction is possible in the coming quarters of 2012, and by the year end, albeit by little, it can be positive, a little above zero.

The agricultural sector (*"Agriculture, forestry and fishing"* with a 4.8% share in GDP for 2011) declined in 2011 due to drops in the first half. Since the second quarter of last year, i.e. for a fourth consecutive quarter so far, growth is recorded on a quarterly basis, which is accelerating. Expectations for a weak first quarter of 2012 - given the unfavourable weather – were not justified, on the contrary - a double-digit annual growth was registered. The year seems to be good in terms of harvest and this is the reason to expect growth in agriculture for the 2012.

The greatest decline in 2011 (by 8.1%) was in sector *"Culture, sport and entertainment; other activities; activities of households as employers; undifferentiated activities of households producing goods and services for own consumption; activities of extraterritorial organizations and services."* Its share in GDP is the lowest among the 10 sectors of the economy - in 2011 it was only 2.1%. Its dynamics continues to deteriorate - for the first quarter of 2012 declines deepen both on

an annual and on a quarterly basis. There is no credible reason so far to expect a recovery to growth in "*Culture, sport and entertainment ... , etc.*" on an annual basis by the end of the year.

It is noteworthy mentioning the upward trend of the business climate in services registered by NSI business surveys in services (excluding retail) for April, May and June. This may mean that for the second quarter of 2012 a better performance can still be expected (compared to the first one) in any of the above service providing sectors, in the dynamics of their added value.

What is special about the dynamics of the components **on the consumption side of GDP** until the first quarter of 2012? First – foreign trade in goods and services is stagnating. *Exports of goods and services* no longer grow but shrink - data for the first quarter show a decrease both yoy (by unadjusted, and by adjusted series) and on a quarterly basis. *Imports of goods and services* also drop on a quarterly basis and on an annual basis - increase slightly by unadjusted series, and by adjusted are at zero. A substantial increase of exports and imports of services may be expected in the second half of 2012.

For the first time since the fourth quarter of 2008, investments register annual growth, albeit modest – by only 1.3% of unadjusted data. According to adjusted data, however, they are shrinking yoy and grow just a little on a quarterly basis. Investment dynamics is expected to get more active in the course of the year.

Final consumption is fluctuating around zero since the second quarter of 2010. For the first quarter of 2012 it grows by 1.5% yoy and declines on a quarterly basis (by 0.5%). For the second quarter it is likely to stagnate around zero. **A more significant movement towards growth is possible in the second half of the year.**

As of July 2012 the economy seems stagnant with weak expectations for improvement in the second half of the year.

For the first five months of 2012 BNB reports a negative **current account** balance of payments (Euro 671.6 million, or 1.7% of GDP). A year ago, i.e. January - May 2011, it was also in deficit, although much lower (Euro 99.9 million, or 0.3% of GDP)¹.

The deficit, as usual, is formed mostly due to the *trade deficit (FOB / FOB)*. For the period January - May 2012 it is negative at the amount of Euro 1,654.2 million, or 4.2% of GDP, compared to a deficit of Euro 668.8 million, or 1.7% of GDP over the same period of 2011. This worse trade balance is due to the freezing of exports and the continuing, albeit slower, growth in imports. The balance under *Income* also remains negative, but is shrinking, i.e. improving compared to a year ago.

The positions in services and transfers are positive components of the current account. The balance of *services* remains positive, as was a year ago but lower. *Net current transfers* are also positive as a year ago, and besides, they are growing.

Expectations are that throughout 2012 the current account will be negative, but relatively small in size.

Foreign Trade. For the five months of the year the value of *exports (FOB)* increases by 0.9 per cent over the same period of the previous year and amounts to Euro 8.1 billion. The continuing economic uncertainty in the EU accounts for a decrease of 0.7 per cent of exports to this market, while exports to third countries grow by 3.3 percent. *Imports (CIF)* experience a continuing

¹ With GDP of Euro 39, 719 million for 2012 (BNB estimates) and Euro 38, 482.6 for 2011 (NSI data as of 6 March 2012).

increase (by 12.1 per cent for the five months) to just under Euro 10.3 billion. Again, rates vary - while imports from the EU are growing by 9.5 per cent, imports from third countries perform better, increasing by 15.8 percent. Thus, the share of EU exports and imports drops respectively from 61 and 59.3 to 60 and 58 per cent for a year. The deficit in *trade balance (FOB/CIF)* reaches Euro 2.15 billion (5.4 percent of GDP), or is almost twice higher than that in January-May 2011. Major changes in the *commodity structure* of trade are related to the fact that almost all commodity groups register a decline in exports and only that of consumer goods increases by 9 per cent. Increase in exports by 10 per cent is seen in machines. Imports show a growth by 30 per cent of purchased investment goods, which means that confidence in the economy grows and companies from different sectors start to implement development plans which were delayed, and FDI inflows is starting to recover. The economic slowdown in Europe has led to shifting supplies and to changes in the *geographical structure*. New markets are present, which do not suffer from financial or economic crisis, such as China, Georgia, Israel, Middle East, to which exports growth is accelerating. Simultaneously with the contraction of trade with EU partners there is another trend – due to decline in consumer demand - for orders of certain goods (clothes, furniture, etc.). which are made in the last minute, with a short delivery deadline, and in this situation the geographical proximity of Bulgaria has a major advantage compared to its Asian competitors.

Data show that Bulgarian exports are successfully redirected to markets less affected by the crisis, and export companies have learned to seek and maintain specific market niches that attract specific customers with specific requirements. It is difficult to say how exports will develop in the coming months of instability of the EU economy, even if not sinking into recession it will go through a prolonged period of slow recovery. Currently, orders from EU partners remain at the level of last year and no export growth is expected. Certainly ***the growth of Bulgarian exports this year will be much smaller than before - no more than 5-6 per cent yoy.*** At the same time, ***imports will continue to grow with accelerated rates over exports.*** The fact is that despite the uncertain economic environment, the greatest increase is in investment goods, which create a productive potential and business plans for expansion. In this sense, the increase in imports can be assessed as a positive phenomenon.

It can now be said with greater confidence that the bottom in attracting **FDI** was reached in 2010 and ***investments will continue to grow, albeit at a slow pace*** due to the caution of private investors, given the uncertainty in the euro area, and the problems with business environment in the country. Two other processes will be developing in parallel - the withdrawal of investors forced by market conditions to reassess their investment strategies and restructure their investment; and their replacement by others, expanding their production or diversifying its range, shifting activities from facilities closed in their home countries, to improve efficiency and achieve price competitiveness. The result for now is an increase in FDI inflows by over 6 times to Euro 473.8 million (1.2 percent of estimated GDP) for January-May 2012. At the same time the structure of investments is improving: the share of private equity is increasing (73 percent), and they are long-term investments; the share of real estate is decreasing (20 percent for the first 5 months); capital outflows in the form of intercompany payments is delayed, even the inflow of loans exceeds payments.

Analysis of results shows that there is still no adequate policy to attract FDI - low taxes and labor costs are short-term solutions, a long-term solution means to set a transparent frame of continuity in all government decisions and actions in order to improve and accelerate the work of institutions, to create a more favorable business environment, to introduce modern education system, directed to the needs of the business, and primarily to provide clarity and predictability in the actions.

Efforts to attract investments should be focused on sustainable areas, interest in which did not drop even during the crisis, such as energy, telecommunications, information technology, as well as turning Bulgaria into a promising destination for exports of peripheral production of companies from the automotive industry, food industry, precision manufacturing, and service centers.

By mid-2012 consumer **inflation** in the country is low, a significant increase will be registered in July data - due to increased prices of electricity and fuel.

By the *Consumer Price Index (CPI)* monthly inflation for June 2012 is actually deflation (minus 1.0 percent), and since the beginning of the year only 0.5% increase has been accumulated (June 2012 over December 2011). According to the *Harmonized Index of Consumer Prices (HICP)* deflation for June is lower (minus 0.5%), inflation since the beginning of the year is higher (0.7%). Consumer prices according to the *Consumer Price Index for the Small Basket* (in June by 1.4%). The inflation accumulated under this index is only 0.1 percent by June.

The business price expectations show no particular pressure - until June when the NSI survey among the business shows expectations for a certain rise in sales prices in the industry only, and for maintained price levels in construction and retail, while in services - even for a reduction. It should be remembered that since 06 January 2012 a new excise duty entered into force, on gas used as motor fuel and for heating by consumers of natural gas for industrial purposes. Besides, after the July increase in electricity prices it can be expected that not only the expectations of the business will change, but these prices will be calculated in all prices to final consumers.

In the second half of 2012 it can hardly be expected that the delicate movement of final consumption will support consumer price inflation, even the opposite is possible - actual inflation and consumer expectations could press final consumption. They are expected to accumulate effects in changes of international prices, especially in fuel and food commodities. Thus, ***the accumulated inflation by the end of the year may exceed 3%.***

In early 2012 the number of **employed** in the economy decreases, and the rate of decrease continues to shrink. For the first quarter employment decline is 1.6% yoy. Two of the 10 sectors are experiencing growth in employment - "*Creating and distributing information and creative communication*" and "*Financial and insurance activities.*" Three sectors register growth in number of employed – the above two sectors and sector "*Professional, scientific and technical activities; administrative and support activities.*" This increase in employed in the three sectors is another reason to expect recovery to growth pretty soon. Self-employed register growth in most sectors.

Quarterly data on labor force for the beginning of 2012 show an increase in the number of **unemployed** and in unemployment rates in all observed groups. The total number of unemployed in the first quarter of 2012 is assessed by monitoring 421.4 thousand, and is by 4.8% higher over their number a year ago. *Unemployment rate* increases to 12.9% (by 0.7 percentage points on an annual basis). Over half of all unemployed are *long-term unemployed (for a year or more)* - 226.7 thousand or 53.8%. They are by 7.9% more than in the first quarter of last year. The number of unemployed young people *aged 15-29* is growing to almost 140 thousand, so *unemployment rate* in this group is already 23.0% (by 1.7 percentage points higher over the first quarter of 2011). The coefficient in the group aged 15-24 is even higher (31.5%), and for a third year its quarterly peak is in the first quarter and continues to grow.

Registered monthly unemployment started the year at levels above 11%, but towards mid-year slightly declines to 10.8% in June, but the series of Eurostat monthly unemployment rate in the country is over 12%. By mid-year labor offices have registered 354,825 unemployed. The severe problem of high youth unemployment could hardly be solved with initiatives such as the scheme

"Creating youth employment by providing opportunities for internship." With over 70 thousand registered unemployed youths (by 29 years of age), the announced in June 1,300 internship jobs under the scheme, although nearly twice as many compared to the previous month and nearly 15 times more over the same month in 2011, they are still too insufficient.

Expectations of the business (as of June) and those of consumers (as of April), registered in NSI surveys are low and suggest that we should be prepared for another rise in unemployment.

Due to the unconvincing performance of production in the economy in the first quarter and due to the general stagnation among Bulgaria's major partners, and expectations that stagnation will turn into weak growth by the year end, ***there is no expectation for substantial improvement in total employment in the economy. Harmonized unemployment may be maintained at over 12% until the year end.***

ENTERPRISE POLICY. There are no significant changes in enterprise policy or improvement in the business environment in recent months. Irregularities in procurement procedures are still continuing. There are still serious deficiencies in the fight against organized crime, despite the efforts, which adversely affect the environment for entrepreneurship.

The government continues to suggest all sorts of controversial **ideas for attracting foreign investors**. Such an idea is simplifying the regime for obtaining Bulgarian citizenship by foreign investors with investments over a certain amount. It is proposed that investors become Bulgarian citizens through naturalization only one year after obtaining permanent resident status, and the investment volume threshold is decreased. Most experts believe that such a move will have no economic effect because although citizenship is a handicap, overcoming it cannot replace the need for improving the overall business environment.

Regarding **innovation promotion**, the construction of a technological park in Sofia ("Sofia Tech Park ") was actively discussed in recent months. Expectations are that this will give a push to innovative development of Bulgarian enterprises. Besides major companies, start-ups in high technology will also work in "Sofia Tech Park". Very likely, funds financing new businesses will be based there. The Ministry of Economy established a company that will be the beneficiary under Operational Program "Competitiveness," and the establishment of funds for financing and training will be agreed with the European Investment Bank. It is not clear why it is necessary to establish a new subsidiary as an independent structure to the already existing "Industrial Zones," but the ambition is to launch the technology park by 2015.

In order to improve the business environment in May, once again, a decision was made to accelerate the work on *introducing e-government*. No matter that an E-government Council was set, which aims at accelerating e-government introduction, this continues to be delayed.

Public procurement continues to be a neurological point in the country's business environment. The Public Financial Inspection Agency (PFIA) in its report for 2011 once again finds serious violations in the field of public procurement. Irregularities have been recorded in 60% of the total number of procedures from last year and in 73% of their value. Changes to the Public Procurement Act are continuing. In general, they seek simplification of legislation in the sector, simplifying the process of procurement, improvement of preliminary control on procurement procedures, which are financed by EU funds. Conclusion can be drawn that the law on public procurement is continuously evolving, but the problem with persisting irregularities is primarily related to its proper implementation.

The judiciary, the organized crime and corruption are continuing to create serious difficulties to citizens and the business. The ***Report for Bulgaria under the Cooperation and Verification***

Mechanism published on July 18, 2012 gives a five-year assessment of progress in the area of justice and home affairs. The report is objective, highly critical, and provides a large number of specific recommendations to the country.

The overall assessment is for a lack of coherent direction in justice and home affairs, which means that the reform process has not built the necessary impetus and turn into a continuous part of Bulgaria's development. Serious deficiencies are the lack of coordinated approach, of efficiency, of policy direction, of clear actions defending the independence of justice; major structural, procedural and organizational weaknesses. The report mentions about cases in which judges are appointed by the National Assembly and the SJC, which are not transparent and are influenced by political considerations; there is a big gap in the workload of courts in Sofia and in other cities; there are serious delays in publishing the reasons for court judgments. Although the intensity of the fight against organized crime has increased since 2010, yet convincing results are lacking in addressing the problem in the pre-trial phase and trial proceedings. There are still many unresolved and delayed cases, and organized crime remains a fundamental challenge to the state and society.

The European Commission addresses specific recommendations and proposes several ***measures that Bulgaria should take***:

Reforms of the judiciary

- Appointment of new members in the Supreme Judicial Council, with a mandate to undertake fundamental reforms.
- Establish and implement a medium-term human resources strategy in the judiciary.
- Election of a new chief prosecutor with a mandate to reform prosecution in its structure, procedures and organization, based on an operationally independent audit and cooperation with external experts.
- Aim at completing the work on the new Penal Code and starting its implementation.
- Provide open commitment of all relevant governmental and professional organizations in defining and monitoring of the reform strategies.

Independence, accountability and integrity of the judiciary

- Focus the work of the Inspectorate on integrity and judicial efficiency.
- Define a uniform, efficient system for random allocation of cases at national level.
- Identifying transparency, objectivity and integrity as top priorities in evaluations, promotions, appointments and disciplinary decisions of the judiciary.

Effectiveness of the court trial

- Establish a strategy to reduce the backlog in publishing the reasons for judgments and analyze how to overcome this problem.
- Effective enforcement of judgments.
- Implement a strategy to improve the legal order, including a pro-active strategy by the Supreme Court.

Fight against organized crime

- The new committee on confiscation of property to be formed based on principles of integrity.
- Active cooperation of the prosecution with committee on confiscation of property.
- Implement an independent analysis when cases fail due to weaknesses in the investigation, prosecution, witness protection, economic and financial analysis, collection of evidence by the police and cooperation between the judiciary and the executive power.

- Deal with defects in the structure, management, recruitment, training, cooperation and professional practice.

Fight against corruption

- Using lessons learned from past cases to improve the actions of police, prosecutors and judges.
- Carrying out an independent assessment of the impact of the national anti-corruption strategy in Bulgaria.
- Delegating the task of coordinating the fight against corruption to one institution, to cooperate and coordinate efforts in different sectors, to report the results from the anti-corruption strategy in all public services and to support new independent monitoring system, which will include civil society.
- Amendment to the Law on conflict of interest, which will allow dissuasive sanctions.
- Review the system for reporting and verification of property in order to turn it into an effective mechanism against growing rich through unlawful activities.

The monitoring of Bulgaria and Romania will continue, the next report for Bulgaria will be published at the end of 2013. The purpose is to give the country the time to achieve visible results.

The **privatization process** is expected to register a weak year in Bulgaria. Lack of investor interest in major projects, and the focus of the Agency for Privatization and Post Privatization Control (APPC) on selling real estate, is the real situation of privatization process in mid 2012.

APPC initiated the sale of three companies: "Technoexportstroy" EAD, "Railways - Freight Transport" EOOD, and "VMZ" EAD, Sopot. After two unsuccessful tries, APPC announced a new privatization procedure for 100 per cent of "Technoexportstroy" EAD, Sofia. APPC announced a one stage public tender for 100 per cent of "Railways - Freight Services" EOOD, Sofia, property of "Holding Bulgarian State Railways" EAD. The justification announced for this decision for termination of the privatization procedure - lack of strong investor interest at the early stage of the competition and the inability to carry out a competitive tender for sale of the company, the Agency for Privatization and Post Privatization Control closed the privatization of "BDZ-Freight Transport" EOOD on July 18, 2012. On July 6, 2012 a procedure was announced for privatization of "VMZ" EAD, Sopot.

The Parliament passed the Law on Public-private Partnership. Changes significantly altered the scope of public-private partnership - they exclude ports, roads, airports, railway stations, road constructions and other objects of road infrastructure. The law in force for them, as before, is the Act on Concessions. The new law regulates matters related to concessions. The new regulations are related to changes in already signed concession agreements, including amendments to the object of the concession. The law will not regulate concession relations, entered into force before September 1, 2012 or already opened concession procedures, which are to be completed by that date.

The government failed to develop **concession procedures** for major infrastructure sites - ports, airports and railway stations. Lack of interest from investors led to closing the procedure for concession of "Civil airport for public use Ruse," and to extending the deadline for submission of applications for tenders in the open procedure for the concession "Civil airport for public use Gorna Oryahovitsa" to 3 December 2012. The Council of Ministers opened a procedure for concessioning port Rousse-West on July 18, 2012, for a period of 35 years.

PUBLIC FINANCES. The state of the balance of public finance in the country continues to improve, and in May accumulated revenues exceed total expenditure by BGN 67 million – for the

first time in 35 months of budget deficits. In the same period previous year the financial balance was negative amounting to BGN 600 million. The better performance in 2012 is entirely due to the national budget, which although starting the year with a deficit of BGN 209 million, records an increase of BGN 334 million as of May. However, the deficit of EU funding increases - from BGN 88 million in January to BGN 267 million as of May.

Higher revenues are due to growth in revenues from the two main revenue sources - VAT and excise duties, which for the first five months of 2012 increase correspondingly by 16% and by 7% on an annual basis. Several effects have a positive impact on revenues. On the one hand these are the higher prices of energy resources and raw materials, which put pressure on prices of investment and consumer goods. On the other hand in the first quarter a slight recovery in domestic demand is observed - consumption and investments. Last but not least, the steps taken to improve the collection of indirect taxes should be taken into account, such as connecting the cash registers of businesses, including those of the fuel system with the NRA.

The four major expenditure groups – salaries and wages, current maintenance, capital, social costs and scholarships – their changes on an annual basis for the first five months of 2012 range between a decrease of 0.9% and an increase of 24.7%. Though slowly, spending on salaries continues to increase yoy – by 1.7%, which shifted their trend to a decrease in the same period last year. This development of expenditure does not match the commitment of the government for optimization of administration. This trend strongly contrasts to current maintenance costs, which for the first five months decrease yoy, although recording an increase at the beginning of the the year. These costs primarily include costs for fuel, energy, outsourced services, repair, medicines, supplies, salaries and other payments to staff.

In early July Bulgaria issued global bonds in euros worth Euro 950 million or BGN 1.85 billion. In general the issuance of global bonds seems to be successful by several indicators. First, emissions with same maturity of countries with a credit rating similar to that of Bulgaria, such as Ireland, Italy and Spain, have achieved yields of 5 - 5.6%. This most clearly shows that investors are less interested in the credit rating of a country and more in the fundamental indicators such as level of debt, budget deficit, and prospects for development. Second, the issuance was oversubscribed over six times, which means that they have received requests for the purchase of nearly Euro 6 billion. Third, the bonds is sold at a time when international financial markets are still experiencing great uncertainty and debt problems in the euro area seem far from resolved.

The tax policy in the country remains relatively predictable, with few exceptions, such as the introduction of new excise duty on methane, which came into force on 1 June. However, higher minimum insurance levels were introduced at the beginning of the year, and on May 1 the minimum salary was increased from BGN 270 to BGN 290. Other conditions being equal, both measures should have a positive effect on tax and security collection, but data suggest otherwise. The number of secured persons decreases in the first five months of 2012 compared to the previous year, and so does the revenue collected, although the average insurance income rises.

SOCIAL AND HEALTH POLICY. The second quarter of 2012 does not propose changes in the social areas. Continuing major social problems are still unresolved, and and pose a risk for social and political discontent. There are others problems which have been present since recently, but will have long-term consequences. There is no consistent social policy to solve specific social problems, or to help meet targets for achieving sustainable economic growth. What we mean is social policy in the broadest sense, including labor market policy, social security and social welfare, health and education.

Continued reform of the pension system is needed in order to achieve financial sustainability and adequacy of pensions. As a minimum, critical decisions should soon be made regarding retirement age and equaling it for men and women, and restricting the access to disability pensions and other unpopular measures.

Another important area that requires a targeted government intervention is youth unemployment, which is a clear case of structural unemployment. The education system in Bulgaria cannot respond adequately to the needs of the labor market and provide it with personnel possessing theoretical knowledge, practical skills and experience. It is necessary to solve the problems of school drop out, specializing and career guidance of students, introduction of the dual system of education and other pressing issues. Otherwise there cannot be expectations for higher labor productivity, growth or competitiveness of the economy.

The new appointments in the healthcare system - the Minister of Health Desislava Atanasova and the Director of the NHIF Dr. Plamen Tsekov - try through separate measures and initiatives to solve some problems of the unreformed health system in the limited time remaining till the end of the term. Unfortunately, the impression is for rather unreasonable and poorly justified, poorly-prepared or coordinated actions.

FINANCIAL SYSTEM. As of June 2012 the assets of BNB increase significantly both on an annual basis and compared to the previous quarter, reaching their highest value since November 2008. Compared with same period of 2011 there is an increase in all items, the most significant increase is in liabilities to banks. Compared to the end of the first quarter the most significant increase is in the Fiscal Reserve of BNB, which reaches BGN 4.75 billion. Decrease is observed only in deposits of "Banking."

In the second quarter of the year the monetary base (notes and coins in circulation and deposits from banks) increase both over the preceding quarter and yoy, with both components increasing.

As of May 2012 the banking system remains stable. Liquidity and capital adequacy remain high. Total assets increase both on an annual basis, and compared to December 2011. The capital and reserves of banks in Bulgaria also increase in volume. In the first five months of the year, however, the negative trend in net financial and operating income remains. The decrease in interest income is accelerating, while interest costs continue to increase. Administrative costs also follow an upward trend, and profits generated by the sector are shrinking. Borrowings from individuals and households continue to grow, ensuring stability of the deposit base, but have a negative impact on the profitability of the banking sector due to their relatively high cost.

The gross loan portfolio of banks in the reference period increases both yoy, and compared to the end of 2011, but expositions to citizens continue to shrink, and the rate of increase of mortgage loans continues to slow down, and at the end of May is negligible. The amount of bad and restructured loans increases and by May their volume reaches its highest value.

The poor economic situation in the country is the major risk bearer to the stability of the banking system, this economic situation being characterized by weak investment activity and domestic consumption by households, uncertainty regarding future income, accompanied by rising levels of unemployment. These factors determine the deterioration of the loan portfolio and the reduced demand for loans and the higher interest costs limit the ability of banks to generate income. Given the uncertain economic environment no improvement can be expected in the banking system in the short term.

In the first quarter of 2012 the volume of the leasing market continues to shrink, albeit at a slightly slower pace. After the balances of new loans grew throughout 2011 on an annual basis, at the beginning of the year they decline again. Non-serviced loans decline slightly compared to December, but their share in the total amount of claims remains relatively unchanged. The deterioration in the leasing sector results from the continuing negative effects of economic crisis - weak investment activity, limited domestic demand and uncertainty in consumer expectations for recovery of the economy, against the backdrop of rising unemployment. Prospects for companies in the sector depend on the general recovery of the Bulgarian economy, so that in the short-term no substantial improvement can be expected on the market of leasing services.

The insurance market also continues to shrink in the first quarter of 2012 and in April its decline deepens. The gross premium income in determining the market of general insurance sector decreases on an annual basis for each of the first four months of the year. Decline in sales is present in three of the four leading general insurance segments: "car insurance, related to the possession and use of motor vehicles," "Land vehicles (excluding rail vehicles)" and "Insurance against fire and natural disasters." The most significant reduction is in the gross premium revenue in the insurance with the greatest share in the general insurance portfolio - "car insurance, related to possession and use of motor vehicles," although it is mandatory, which, given its increased price indicates a reduction in the scope of the insurance. Claims follow the dynamics of gross premium revenue, but are declining at a slower pace, which limits the profit in the sector. The higher limits as of 01/06/2012 of insurance "car insurance, related to the possession and use of motor vehicles" will put additional pressure on the general insurance companies' ability to generate profit.

The insurance sector continues to suffer the negative effects of the worse economic situation in the country, especially from the shrinking consumption, which is a major obstacle to recovery of the sector. Given the general state of the Bulgarian economy, the rising unemployment and dropping household incomes, no significant improvement can be expected in the conditions of the insurance market in the short-term.

Capital Market. In the second quarter of 2012 two of the four stock indices devalue (SOFIX and BGTR30), while the other two (BGREIT and BG40) increase their value. The number of transactions continues to decline (by 16.1% over the first quarter), while turnover increases by 93.7%. In the last quarter the blue chip index SOFIX loses another 5.2% of its value and BGTR30 loses 7.6%. The sector index for companies investing in real estate BGREIT has a generally upward trend since the beginning of the year, and in the second quarter gains 13.1%. The broader BG40 index also increases, reaching 107.47 points at the end of June.

In the second quarter of 2012, the sectoral structure of the stock exchange turnover again experiences substantial changes – the traditionally dominant sector of financial and insurance activities accounts for only 27.2% of the turnover, the decrease is mainly at the expense of the share of manufacturing, which rises to 62.6 per cent. Turnover of companies engaged in real estate transactions also increases significantly. The other sectors account for only 2.5% of the turnover on the general BSE market.

ENERGY. In early May a *project company* was established "NPP Kozloduy - New facilities" for the construction of block VII of "Kozloduy" NPP. Within six months the working group should develop a program and the government should make a decision in principle for the new block.

In late May, the Bulgarian Energy Holding announced that it completed the procedure and *a consultant was selected for the division of NEK EAD and ESO EAD*. This is done in order to introduce the requirements of the Third Energy Liberalisation Package of the EU.

In late May, the government approved the *Third National Action Plan on Climate Change 2013-2020*. Its main strategic objective is to outline the frame of actions on climate change for the period 2013 – 2020. The general effect of measures by sectors expressed in the projected reduction of greenhouse gas emissions by 2020, is estimated at 44, 832 million ton of CO₂ eq.

In early July the European Commission approved the request of Bulgaria, the Czech Republic and Romania for continued free allocation of allowances under the European emission trading scheme. Bulgaria will be allocated 54.16 million free allowances.

There are still some open issues between Bulgaria and Russia concerning the construction of pipeline "South Stream" on the Bulgarian territory. In May the Parliament ratified the agreement to support the pipeline project "Nabucco." Most progressing among the projects for construction of gas interconnections with Romania, Greece, Serbia and Turkey is *the interconnector with Romania*. In late April, the Bulgarian Energy Holding EAD and the State Oil Company of Azerbaijan Republic (SOCAR) signed a Memorandum of Understanding to expand the mutually beneficial cooperation in the natural gas sector and in the supply and marketing of petroleum products.

In early July the Ministry of Economy, Energy and Tourism announced *the results from the competition for gas exploration in deep waters of the Black Sea* – the so-called block "Khan Asparuh." First in ranking was the big French company "Total." It will work together with the Austrian OMV and the Spanish "Repsol" and the permit is for a period of 5 years.

In June MEET published the *draft on Amending the Law on energy efficiency* for public discussion. These are changes needed for the transposition of Directive 2010/31/EU of 19 May 2010 on the energy performance of buildings.

In early July the Parliament adopted the **Law on Amendment to the Energy Act**. The Act reflects the requirements of the third energy liberalization package. It introduces all the requirements for independence of the gas and electricity grids, the conditions for equal access to transmission grids of all participants in the energy markets and broaden the powers of the regulatory body - SEWRC.

TRANSPORT. According to preliminary NSI data in the first quarter of 2012 *goods transported by road and water transport decrease* by 0.4% compared to the fourth quarter of 2011, and passengers transported by land, water and urban electric transport - by 2.8%.

In July, two lots of "Trakia" highway were launched of total length 67.5 km. On July 1 2012 Lot 2 of "Stara Zagora - Nova Zagora" was launched (length of 31.8 km), and on 12 July - Lot 3 "Nova Zagora - Yambol." The construction still continues of Lot 1 "Dolna Dikanya - Dupnitsa" and Lot 4 "Sandanski - Kulata" of the "Struma" highway, and Lot 1 of "Orizovo-Dimitrovgrad and Lot 2 of "Dimitrovgrad -Harmanli" of "Maritza" highway.

In early May a procedure was opened for signing concession contract for the design, construction and operation of the high speed road Ruse - Svilengrad. In late June representatives of Bulgaria, Turkey and Qatar decided to establish a small project company to carry out feasibility studies and analyses for the construction of the road. In late June the government adopted a decree for directing funds to National Company "Strategic Infrastructure." According to MTITC at the end of June 82% of the physical implementation and over 90% of the financial implementation under the contract for construction of Danube Bridge 2 was accomplished. On July 1 the reconstructed

railway section Plovdiv - Dimitrovgrad was launched, part of the project "Reconstruction and electrification of railway Plovdiv - Svilengrad - Turkish/Greek border." Within this project in July a Center was opened for centralized management of rail traffic.

TOURISM. According to NSI data in May 2012 visits of foreign citizens to Bulgaria are by 4.6% less than in May 2011. The largest decline is in visits for holidays and excursions, followed by those for professional purposes. Visits of EU member states national in May 2012 decrease by 8.6% yoy. However, the number of Bulgarian citizens who have traveled abroad, increases by 4.6% and the increase in travel for tourism and recreation is 59%.

Projections for 2012 are favorable - they are for a growth of tourists by 10% compared to last year. The greatest growth will be in tourists from Russia. Russia is the fourth country by number of tourists to Bulgaria. Romania comes first, followed by Greece, and Germany takes the third place. Preliminary financial analysis shows that in 2012 revenues from tourism will exceed Euro 3 billion. Last year's revenues from tourism in Bulgaria's balance of payments were a little over Euro 2.6 billion. There are prerequisites for positive expectations - the preliminary data on revenues from tourism for the winter season as well as data on bookings for the summer season. It is, however, possible that favorable forecasts may not turn true in the conditions of crisis. No assessments can still be made on how the terrorist attack in Bourgas airport will affect tourism. For the time being it is not expected to have major impact on the number of foreign tourists.

In June 2012 the Council of Ministers adopted a draft Law on Tourism and entered it to be passed by Parliament. The new law aims at creating conditions for sustainable development of the sector and increasing its competitiveness. The Law, besides development of mass tourism, also includes opportunities for the development of specialized types of tourism - cultural, balneological, spa and wellness, rural tourism, eco tourism, congress, youth, adventure, hunting, golf and others. It envisages the establishment of uniform criteria for tourist activities and for travel services. Attention is paid to the protection of consumers of tourist services. The main advantages of the Law relate to simplifying the business environment and increasing the competitiveness of the sector; better coordination in the management of tourism at national level; creating bodies of representatives from the tourism sector; division of the country into tourist regions; improving the quality of services and consumer protection.

Changes will be made in the management of tourism - tourism management will be moved from Sofia to Plovdiv. The change is in implementation of policies pursued by the government on decentralization and relocation of part of the administrations of the central executive power outside of the capital. Decentralization is done in conjunction with the intent to promote specialized forms of tourism. It is to be seen what will be the positive or negatives consequences of such a decision. Funds for advertising and marketing in tourism are still insufficient. In recent months, the Ministry of Economy, Energy and Tourism signed with the Managing Authority of OP "Regional Development" five contracts for tourism development, at total amount of BGN 20.5 million. Over BGN 2 million will be spent on surveys and analyses on the effectiveness of national marketing and over BGN 3 million is intended on promoting domestic tourism, about BGN 6.2 million is to be spent on advertising Bulgaria in the foreign media.

AGRICULTURE. In the conditions of economic stagnation and reduced share of industry agriculture increases its share in GVA and GDP. Despite fears, the grain harvest seems to be very good both in terms of quantity (4 million tons of wheat and 700 thousand tons of barley) and quality (indicators of grain harvest are estimated as the best in years). Prices have already increased by 10-15 per cent over last year and it looks like they will continue to grow due to higher demand on the international market, the drought in the U.S., forecast for a reduced crop in Russia

and rains in southern Russia during harvest season. The land market records a new trend - although most valued is the land in Dobrich, growing interest is manifested in agricultural land in northwestern Bulgaria. The trend is of growing land price by 10-15 per cent yoy. Rents are growing even faster - up to 20 percent. Key actors in the market are agricultural land funds. New investors are entering whose core business is different, providing additional resources.

There is a steady trend of concentration of production in the sector, as evidenced this year again in the reduction of number of applicants for EU subsidies, and the parallel increase in registered area. This consolidation of farms in agriculture makes them more efficient because it allows for mechanization of production. The expected good harvest this year and the already received permission to transfer funds under the Rural Development Programme to the scheme for modernization of farms will accelerate the replacement of machinery and equipment, will keep relatively high interest to purchasing new equipment and will improve efficiency in the sector.

REGIONAL POLICY AND EUROPEAN FUNDS. *The implementation of operational programs* continues. At the end of May 2012 75% of planned for this programming period Euro 8 billion were contracted but the amount paid out is still a little over 22%. In terms of contracted funds best performing is OP "Transport" with total contracted over 92% of resources provided under the program, and 29% paid out. The most unfavorable situation is in OP "Competitiveness" (with contracted only 44% of the resources), the share of money paid out under this program, is relatively high - 25%. In terms of resources paid the lowest rate is in OP "Environment" - only 12.5%. 2012 is crucial for the program implementation, because a substantial part of payments should be made, which were contracted last year.

In the next programming period Bulgaria is likely to receive some Euro 8.6 billion from EU funds (excl. agricultural funds), and with the national co-financing the amount will reach Euro 10 billion. The exact amount of funding is still subject to negotiations. *Developing the necessary documents for the next programming period* is very important. By mid-2013 Bulgaria should be ready with its position on EU funding - to identify specific measures and to define its national priorities by 2020. A long debate is forthcoming, during which each member state will defend its interests on how the allocation of money from the general EU budget should be done. The main documents that Bulgaria should develop by 2013 are: partnership agreement with EU; Law on management of EU funds; operational programs.

Bulgaria is lagging behind with the development of new operational programs and the partnership agreement with the European Commission for 2014-2020. These documents are extremely important - in fact they are programs for a serious reform of whole sectors. The work on their development has begun but there is a serious delay. It is necessary to consider measures under the programs seriously, and to avoid directing financial resources to inadequate measures. Requirements for operational programs in the new programming period are very high, and intermediate objectives are envisaged - for 2016, 2018 and 2022, when the absorption periods will have expired. Failure to reach intermediate objectives can lead to suspension of funds.

In order to enable better absorption the government developed a Concept for the development of EU Fund Management Act. The concept proposes a vision on the scope, structure and content of the future law, which will regulate the administrative, legal and civil relations in the management of EU funds in the programming period 2014 -2020, as well as some aspects of implementation of programs in the current programming period. The law will allow for transparent settlement of public relations on the EU fund management by creating a predictable environment for operational programs implementation, with clear statutory rights and responsibilities of participants in the

process; it will deal with existing fragmented regulations; it will allow codification of implementation procedures and will accelerate appeal decision.

The adopted the Law on public-private partnership is very important for the successful absorption of EU funds, too. It will enter into force on 1 January 2013 and will create more opportunities for active involvement of private businesses in the development of state and municipal infrastructure. The Law on public-private partnership will complement the EU funding.